



## Episode 655: Economist Goes Very Wrong on Business Cycles; We Correct Him

Guests: Jonathan Newman & Joe Salerno

**WOODS:** I'm going to of course link to your article, Jonathan, on our show notes page, [TomWoods.com/655](http://TomWoods.com/655). I'll link to the Steve Horwitz article as well. People can read it for themselves. What this piece is saying, in a nutshell, is that although Austrian business cycle theory can tell you something about what causes the unsustainable boom, that's as far as it can go. It can't tell how the bust will play out and how severe it will be. And moreover, it suggests that maybe even it's the case that not all booms can be accounted for by means of the Austrian theory of the business cycle, and Horwitz identifies himself as an Austrian economist, as far as I know, so it's important to respond to this.

I actually had people who listen to this show email me this article and say, what do you think of this, and I hadn't seen your response. I came upon your response, so I thought, all right, let's get Jonathan on here and we'll talk about it. I want to go in order. Let's just go right in the order in which the article presents the points. Why don't you start off, especially because I don't want to assume absolutely everybody listening already knows what Austrian business cycle theory is. That's not what I want to do in this show. I want people to feel like they can listen to it at any level of understanding. So tell me what Austrian business cycle theory can tell us, and what in fact does it tell us. What do we learn from it?

**NEWMAN:** Sure. Austrian business cycle theory gives us a pattern of cause and effect that we can use to interpret historical episodes, and also, just in economic theory we know what can happen after what and what are the consequences of certain policies. And the specific policy that it points out is the artificial credit expansion on the part of central banks, and so when central banks do this, there are certain consequences, and those consequences being there's overconsumption and malinvestment. And Austrian business cycle theory says what necessarily must happen as a result of that policy. What it can't tell us, and so Horwitz is right in his article to say, it can't tell us the precise timing; it can't tell us all the particulars, but it does give us an overarching pattern of cause and effect.

**WOODS:** All right, so let's now go through the three limits of Austrian business cycle theory as Horwitz outlines them. The first one is that Austrian business cycle theory tells us nothing about exactly when the boom will break or the precise factors that will cause it. Now incidentally, I know that in Roger Garrison's presentations of the

Austrian business cycle theory, he is at pains to emphasize that it is a theory of the unsustainable boom. That's what it's a theory of. So in that sense, isn't that all Horwitz really is saying here?

**NEWMAN:** Can you clarify that question? I'm sorry.

**WOODS:** Well, I mean, even Roger Garrison says that the theory is just a theory of the unsustainable boom, and that seems – I'm just playing devil's advocate here –

**NEWMAN:** Yeah.

**WOODS:** – that seems like that's what Horwitz is saying, that this is a theory of the boom, but it's not a theory that tells us when it'll break or what the factors that will cause it will be.

**NEWMAN:** Right, but the thing is, in Austrian business cycle theory, there are things that happen; there are real consequences to what happens during the boom period, and so these are the things that must be corrected during the bust period. So it's not just a boom. Like, the theory doesn't just cover the boom, but it also covers how the wrong things that happened, how well those mistakes have to be corrected in the bust.

**SALERNO:** Yeah, Jonathan is right about that. In fact, it's a theory of the business cycle, both of the boom and the bust. Now, that has nothing to do necessarily with when and where the bust will occur and how long it will take for the bust to cure itself.

**WOODS:** All right, well, the second one of these deficiencies, so-called, of the Austrian theory is it can't predict exactly how the bust will play out. So what do you say to that, Jonathan?

**NEWMAN:** He says that Austrian business cycle theory tells us little to nothing about how the bust will play out, but the thing is, it does give us some indicators of what has to happen during the bust. So the malinvestments have to be liquidated, prices have to fall – or prices have to be adjusted in general so capital can be reallocated to profitable lines of production. So there are all these indicators of things that need to happen during the bust. When we're trying to apply to it to a certain historical episode, obviously you've got to incorporate other things. You have to see what's going on in history. You have to apply the theory in a particular way, and so Austrian business cycle theory as a general theory doesn't make specific claims, except to the extent that wages will do certain things, the prices of factors of production have to do certain things. But in terms of what types of labors or which industries or which factors of production, those prices have to change, it doesn't make those sorts of specific claims.

**SALERNO:** So it does give us what we call a pattern prediction. I mean, it's a real prediction about what factors will occur, and so we know that there are certain

businesses in the higher order or capital goods industries that will collapse or will shrink radically and lay off workers. So we know that there will be a lot of unemployment in the capital goods industries, and, in fact, that prices of capital goods will decline relative to prices of consumer goods. So it does tell us real things that will occur during the bust period. Now, again, because of human volition, it doesn't tell us exactly when it will happen and in what order these things will happen, but it will give us a broad pattern that we'll see in the data. So if you go back and look at the data, you can only find the business cycle itself as sort of an up and a down of business profits, sales, capital goods investment, and so on, because you have the theory prior to that. So it does predict in the Menger sense in an exact way; that is, it predicts the pattern of events or general events that will occur.

**NEWMAN:** And to the extent that we get these imprecise things from Austrian business cycle theory, this is not a deficiency of Austrian business cycle theory per se, but a limit to economics in general. So Horwitz' limitations that he outlines for this specific theory really apply to economics in general. Economics is a science of human action. We can't make these precise timing and the precise play out of the busts. We can't make these sorts of predictions, just in general with any economic theory, because it's economics.

**WOODS:** Right, we can't say exactly when gold is going to hit \$1,600 an ounce or something like that, but that doesn't mean that economics is deficient or needs to be supplemented or we need to wring our hands about it. Now, I want to ask a comparative question about different schools of thought in the business cycle, because what I want to know is, given that Austrian business cycle theory is being criticized here for not giving you apparently a specific enough picture of the bust and not giving you specific enough timing, is there any other business cycle theory that, a) claims to be able to do those things, to pinpoint the timing and the exact working out of the cycle, and b) that has successfully done so?

**SALERNO:** Absolutely not. Neither the monetarists' theory nor the Keynesian theory, except to the extent that they may use econometrics and try to give some more quantitative answers, they don't really claim to be able to give you a timing element when they're talking about the business cycle. And nor have they ever in the past been successful at doing so. In fact, if we recall, up until a few months before his death, Milton Friedman in 2005 had an article posthumously published in *The Wall Street Journal* in which he said the U.S. economy was having an unprecedented prosperity and that anyone who said otherwise was completely wrong. And so he completely missed the fact that we were in a housing bubble. His theory did not allow him to see the pattern of what was occurring with the boom and the bust.

**NEWMAN:** And the other thing along these lines is that no Austrian economist has ever tried to use Austrian business cycle theory as a way to completely explain some historical episode. If you look at Mises, if you look at Rothbard, they've all relied on the economics of intervention, they've all pointed to specific happenings in the culture, and they make guesses about the psychology of the people involved. So

nobody has ever used Austrian business cycle theory in the way that Horwitz is saying people are using it, as a complete, one-stop way of describing some historical episode.

**WOODS:** All right, I wanted to clarify that point, that basically the Austrian theory is being criticized here on grounds that any business cycle theory would be criticized for, at least if not more. And then secondly, Jonathan, you make the point in here, and this is just elaborating on what you just said, that we do learn again about the bust phase, that, given that we know where the boom comes from, we know what's happening in the bust, we know that prices need to adjust, then we therefore know that when the government prevents the adjustment of prices, it's going to prolong the recovery process, because this just follows as night from day from the Austrian theory. So there is plenty more stuff that we can learn, and that's why a historian like Rothbard will go and look at the Hoover administration and look at different ways that the recovery was hobbled because the adjustment process was interfered with. Let's go on to the third limitation that's alleged about the Austrian business cycle theory, and that is that it might actually not in fact be able to account for all the booms that we see in economic history. And I guess here this really depends on what you mean by "boom," so why don't one of you try and clarify that?

**SALERNO:** Yeah, let me take a shot at that, Tom. Horwitz goes on to say in the article in at least three different places that an excess supply of money causes the business cycle. That's a complete misstatement of the situation. In fact, it's not an excess supply of money that causes the business cycle. For example, if the government prints up money to finance a war and then spends it on military equipment and conscripting people and so on. That only causes a simple inflation. It causes prices to rise. It does not cause a business cycle. The reason why that occurs, the business cycle occurs only if there's a falsification of the interest rate, only if the new money enters the economy through the financial markets via, let's say, Fed open market operations. So Horwitz's view of the cause of a business cycle is incorrect. People can just – for example, if you and I become more optimistic about the future, we can start lowering our demand for money and spend more money in the present, and that would also cause prices to rise, but of course you'd get no business cycle.

**WOODS:** Right, so he actually says – he points to excess supplies of money as causing business cycles, but as you say, this is just what Mises calls simple inflation.

**SALERNO:** Yes.

**WOODS:** This is not cyclical. This does not lead to the business cycle. It's the injection of credit through the banking system and the workings of that that lead to the business cycle.

**SALERNO:** Yeah, and more precisely – and this sort of contradicts his monetary disequilibrium view – it is the creation of fiduciary media, and by that I mean simply the creation of unbacked notes and unbacked checking accounts that causes the falsification of the interest rate. So it's not just any plain vanilla increase in the supply of money.

**NEWMAN:** Yeah —

**WOODS:** And yeah, because — oh, I'm sorry, just one quick thing, because this is a point that comes up a lot. If we were living under a gold standard, let's say, a lot of people wonder if we had a big gold discovery, would that lead to a business cycle. I get that question all the time, and this basically answers that question.

**SALERNO:** Yeah, we did have a big gold discovery in 1896. We had prices rising, what's called the Great Inflation. From 1896 to 1913, prices rose by about 1% per year. There was no business cycle that was generated by that big increase in the gold supply.

**WOODS:** Okay, all right, I'm sorry, Jonathan.

**NEWMAN:** Oh, it's fine. I was just going to say, more broadly, in my view, Austrian business cycle theory is really the only sufficient and necessary explanation for business cycles. If you take the view that a business cycle is a general boom and bust, then there's literally nothing else that can cause the widespread malinvestments and the overconsumption that we see in the boom periods. Anything else that we might think of that might sort of look like overconsumption or malinvestment is industry-specific, and so it's not going to be something that applies to the economy as a whole. Or you don't get the boom that precedes the bust. So if a natural disaster were to come through, this would depress our economy. We would have things that look like a depression if something wiped out our capital structure like a natural disaster, but that's not preceded by a boom period. So a business cycle per se is a general boom followed by a necessary general bust, so in that regard, Austrian business cycle theory in my view is the only suitable explanation.

**WOODS:** Rothbard dealt with this somewhere, where he said that of course we can all see why there would be an economic contraction if we had, say, a plague that killed two-thirds of the population. We would understand where that came from. Or if there's a war, well, this leads to the breakdown of the capital structure and can lead to less production and all kinds of suffering. We would be able to pinpoint exactly what the specific cause of this contraction is. He says what economic science is trying to figure out in business cycle theory is not those things. So if it's going to be alleged that, well, Austrian business cycle theory can't explain those, I don't need Austrian business cycle theory to explain those.

**NEWMAN:** Exactly.

**WOODS:** But secondly, it's the general boom and bust that doesn't appear to have this type of specific, historically contingent factor behind it as an explanation.

**NEWMAN:** Right.

**SALERNO:** Yeah, I want to jump in here and I want to mention something that's a follow up to what Jonathan just said. So Austrian business cycle theory, we don't need anything to complement it in explaining the business cycle. Now, Horwitz lists a few

works by other authors that you may use to supplement the Austrian business cycle theory in explaining the length and depth of the Great Depression. And what's interesting is he mentions Friedman and Schwartz's work, *A Monetary History*, in which they blame deflation caused by Fed contraction, deliberate Fed contraction, as the main culprit for the Great Depression.

And then he also mentions work by UCLA macroeconomist Ohanian. But Ohanian's explanation for the Great Depression is completely antithetical to what Friedman and Schwartz say, and what's interesting is that Ohanian basically repeats Rothbard's argument about why the Depression lingered on. So Ohanian says that the biggest, single most important element in precipitating the Great Depression was significant labor market distortion, meaning that Hoover held wage rates above their market level. So he does not blame the deflation. In fact, he goes on to say, in other recessions and crises, prices fell, we had significant deflation, but wages also fell. So he blames it on a labor market failure, not on a Fed failure. So it's interesting that Horwitz would cite both of those, which contradict one another, as being other theories that you need to supplement the Austrian theory.

**WOODS:** Can you say something about, in a layman style, about the controversy – I don't know if this can be done, Joe, but if anyone can do it, you can – the controversy over so-called monetary disequilibrium theory, because there is a difference of opinion among what we might say different sub-branches of the Austrian school on this question, where they would justify and say that – they would talk about fractional reserve banking and not argue about the legality or any of that question, but argue that we need it for the sake of bringing about economic stability, basically. Can you explain that and what's wrong with it?

**SALERNO:** Yeah, let me start with, historically the capitalist economy is extremely productive. It leads to improving technology and increasing capital investment. Now, as a result of that, if you didn't increase the money supply, you would have a fall in prices, which we had from the end of 1879, when we got back on the gold standard, through 1914. And the economy did well. It did swimmingly well. Now, they would claim that that's fine if those fallen prices occur because there's a greater supply of goods and services in the economy. However, if you and I suddenly get pessimistic about the future and we begin to hold more money and spend less, then the fallen prices that result from that somehow damages the economy, and so to forestall any sort of deflation like that, the Fed must inject new money into the economy, in order to keep supply equal to our increased demand to hold money. So that's their view.

The view of other Austrians, such as myself, Murray Rothbard, Mises, Jonathan here, is simply that, look, if you try to offset any type of price decline, whether it be due to greater productivity in the economy or the fact that people are worried about the future and hold more money, you distort interest rates. In other words, there's no difference. You inject new money into the economy through the banking system, which drives interest rates down, falsifies the expectations and profit estimations of entrepreneurs, and leads to the business cycle. So in other words, we would say that any creation of unbacked checking account money or unbacked demand deposits

generates the business cycle. They would claim, oh, no, that's not completely true. In one case, it's not true. In that case – which they don't really explain why – in that case, it's only if prices are falling as a result of people wanting to hold more money. And I guess it would come down – I am not being as charitable as I should be. They would say, well, prices are sticky, so that prices can't fall right away to meet the greater demand for money.

**WOODS:** Now, having said this, let's go back for a minute to the claim – because I'm looking right at the Horwitz article here, and I quoted this part before: "A full explanation from a classical liberal perspective will have to include Milton Friedman and Anna Schwartz's work" – and here's the part I left out – "on the deflation caused by the Federal Reserve during the 1929-33 period." Now, Joe, I know you've written on Fed policy and the effects of Fed policy during these years. Is it accurate to say that the Fed caused deflation, that the Fed's policy was a deflationary policy?

**SALERNO:** No, and I don't want to go into too much detail, but from my research and also from research that was based on my research by Patrick Newman, in fact what happened was the Fed was desperately trying to inflate the money supply. It was increasing the monetary base, but it could not increase the money supply, because at the same time, people were reclaiming their property; that is, the money they had deposited in these banks, in these fractional reserve banks. So they were pulling out reserves faster than the Fed could create new reserves, so the money supply as a result declined. And also adding to the deflation was the fact that businesspeople and households were holding more money, were demanding more money, which put more downward pressure on price. So the Fed was inflationary throughout the whole period from '29 through '31, except for about one or two quarters, where they actually did not try to increase the money supply.

**NEWMAN:** It's very interesting that Horwitz cites *America's Great Depression* in his article, because Rothbard actually touches on this point and many of the other points that we've brought up about the deflation, about whether or not Austrian business cycle theory is a sufficient or necessary or sufficient but not necessary, and the effects of Hoover's labor market interventions. All of this is in *America's Great Depression*, so it's very strange that Horwitz would cite this in his article, where he's making opposite, conflicting claims.

**WOODS:** I want to definitely make sure that I link at [TomWoods.com/655](http://TomWoods.com/655), of course link to the two articles. I also want to link to what Joe's done on this. I want to link to anything I can on the subject of Fed policy during the crucial years of the first four years after the stock market crash. Is there anything we've left out in terms of making a complete analysis of this argument?

**SALERNO:** Yeah, I think there's one thing. In 1931, Mises wrote a short article called "Economic Causes of the Crisis," and in that article he said that, in fact, the crisis, even by 1931, cannot be completely explained by Austrian business cycle theory. It's a crisis of interventionism. The Hoover administration, even by '31, had increased taxes, put on tariffs, and of course interfered with the wage price adjustment mechanism. So

Mises knew that, yeah, you need another theory, but that theory is a single theory, and that's a theory of interventionism. Unemployment cleared up very rapidly. It may have had a year or something of very deep, sharp recession, but if wages and prices had completely adjusted, as they had in the 1920-21 recession, which you've written on, in fact there would be no Great Depression. And by the way, Ohanian in an article in a very prestigious journal, mainstream journal, *Journal of Economic Theory*, makes the same point as Mises that Mises made in 1931.

**WOODS:** You know, I've read some of his articles, and I probably at that time had access to an academic library. Do you happen to know if these articles are available online, or are they behind one of these scholarly journal walls where people have to subscribe for \$300 a year?

**SALERNO:** No, they're available online. His article "What – or Who – Caused the Great Depression?" can be found at the NBER site, which is free, and also at the UCLA site as a working paper. So they're free, and there's not a lot of technical jargon in it. And the best thing about the article is that Paul Krugman hates it.

**WOODS:** Oh, that is an excellent point.

**SALERNO:** Yeah, everyone should read it for that reason alone.

**WOODS:** Yeah, of course, of course. We have a special relationship, let's say, with Paul Krugman here on the show.

**SALERNO:** I would think.

**WOODS:** Yeah, so we're going to link to that as well. Okay, are there any final words from either of you to wrap this up?

**NEWMAN:** Can we plug some Mises Institute stuff, like – ?

**WOODS:** I want you to, and if you didn't, I would be disappointed. Go ahead.

**NEWMAN:** We would just encourage anybody that's interested in learning about Austrian business cycle theory, Austrian economics in general to look up Mises University, and for the most advanced students, maybe in graduate school, to look at RGS maybe for future years. I think they're booked up for this year. And also the summer fellowship. I benefited greatly over the years by participating in the fellowship. I wouldn't be where I am right now, actually, if it weren't for that. So the summer fellowship, Rothbard Graduate Seminar, and Mises University are top notch.

**WOODS:** Yeah, let me say something about that, because I've participated in a couple – actually, I was a summer fellow back before there really was a summer fellow program in the mid '90s. I was just hanging around at the institute for the summer, so we dignified it by calling me a fellow. But the Mises University is the weeklong program for college students. You'll see some grad students and sometimes a handful

of exceptionally bright high school students even make the cut. And it played a formative role in my own life. I cannot say enough about the importance of Mises University. Look that up online. I strongly urge you to attend. Secondly, the Rothbard Graduate Seminar is for more advanced students, and there you have a small group setting with some faculty, and you work intensely studying a particular text, and that's very worthwhile.

And then when I used to live in Auburn, I had a lot of direct interaction with the people who from all over the world came to the Mises Institute for the summer to be fellows and to do research under the direction of Joe and to present their research at the end of the summer. And these were just the salt of the Earth, wonderful people, thrilling to get to know them. It's great to see – Joe, you must feel the same way – to see so many of them now in faculty positions and continuing to forge ahead in their work, and they started off as Mises Institute summer fellows. So if you're thinking of going into economics or a closely related discipline, that is an opportunity, spending a summer at the Mises Institute, that is not to be missed. All right, so – and by the way, Joe, you're still the director of the summer fellows program, is that right?

**SALERNO:** Yes, I am. Yes.

**WOODS:** All right, so you'll work under Joe, and it'll be tremendous. Okay, thanks to both of gentlemen for doing this. I very much appreciate your time.

**SALERNO:** Thank you for having us on.

**NEWMAN:** It's been great, thanks.